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The faculty of borrowing is a more powerful agent, than even gun-powder; but probably the gross abuse that is made of it will soon destroy its efficacy… It is impossible to avoid a precipice, when one follows a road that leads nowhere else.

— *A Treatise on Political Economy*, Jean-Baptiste Say, 1803

THE TWO GREAT EVILS: ASSET INFLATION AND DEBT

Pondering what the coming year will bring, we are, as usual, struck by the unanimity of bullish expectations in the United States. For sure, America is the notorious land of optimists. As we have expounded many times, our main problem with this permanent optimism is that it expresses itself to an unusual extent in borrowing for consumption and speculation, but least of all in saving and borrowing for capital investment.

We have been reading that virtually every sentiment indicator for the U.S. economy and its stock market is showing optimism far in excess of what happened in early 2000, at the height of the stock market bubble. This euphoria, by the way, is unique to the United States.

In recent months, for sure, there has been some excellent news about the U.S. economy's performance. Corporate profits, in particular, have been soaring. But as we have repeatedly pointed out, there is a confusing discrepancy between the so-called early indicators, generally based on opinion polls, and the hard data of actual economic activity, such as numbers for employment, new orders and production.

Focusing on the latter, you see a booming economy. In December the national manufacturing index of the Institute for Supply Management (ISM) had its strongest reading since 1983. Its new orders component surged to its highest level since 1950. The National Association of Purchasing Management-New York's business activity index, which gauges general economic health, skyrocketed to 80.7 in December from 51.9 in November, its best reading since the survey began in March 1993.

A flagrantly different picture has been emerging from the simultaneous Commerce and Labor Department data, measuring hard economic facts, such as employment, new orders and production. While their numbers lately have been less dreary than they were during 2001–02, they grossly lack the vigor that has been typical of past economic recoveries. While the ISM manufacturing index went literally through the roof in November, new orders for capital goods, as reported by the Commerce Department, slumped 5.5% across the board. (These numbers are not annualized.)

The shipment numbers are no better. November shipments of nondefense capital goods — the core component of business equipment spending — declined 0.6%, after increasing 0.8% in October. Compared to a year ago, there is a miserable gain of 1.7%, and of just 2.2% for manufacturing as a whole. Shipments of consumer durable goods in November were no higher than a year ago.

Apparently, it was the burst in U.S. real GDP growth during the third quarter of 2003, hitting an annual rate of 8.2%, that has played a key role in kindling the new growth euphoria. Coming from growth rates of 1.4% in the first quarter and 3.3% in the second quarter, all annualized, for many this was the definite breakthrough toward sustained higher economic growth. A forecast of 4–4.5% of real GDP growth in 2004 quickly became the consensus.

It is our long-held opinion that the American practice to annualize many figures confuses many people in the markets. Looking first of all for the true momentum in the economy and also for international comparability, we principally focus on the flat figures stripped of the customary annualization. Outside the United States, that is the general practice. For us, therefore, America's growth performance from quarter to quarter during 2003 reads as follows: 0.35%, 0.8% and 2.05%.

There was an economic upturn, for sure, but a very weak one in comparison to the postwar cyclical norm. That is, in our view, the first important fact to note. Far more important, though, is a second, also grossly neglected question. It concerns the staying power and the dynamics inherent to the current U.S. economic upturn.

In principle, economic growth can have two flagrantly different sources: *first*, sound fundamentals making for self-sustaining and self-accelerating economic growth; and *second*, artificial monetary and fiscal stimulus. But since both cutting interest rates and running budget deficits have their limits, success or failure of such stimuli essentially depends on their ability to trigger a recovery that quickly develops strong momentum of its own.

In the 1930s, they had a specific expression in this respect — to prime the pump. It was borrowed from life on the farm. When a pump failed to work, it was customary to pour water into its bulk and ferociously jolt the handle until the water came again. But it was very well known that this only worked when the pump was in good order.

A CRUCIAL DIFFERENCE

This is, indeed, the key question about the U.S. economy. Has the huge combined monetary and fiscal stimulus injected into it over the last three years achieved sufficient traction to unleash a solid, self-sustaining and self-accelerating recovery? To quote economic theorist Joseph A. Schumpeter: *"Our analysis leads us to believe that recovery is sound only if it does come from itself. For any revival which is merely due to artificial stimulus leaves part of the work of depression undone and adds, to an undigested remnant of maladjustments, new maladjustments of its own."*

In this respect, the sluggish recovery of the past few years manifestly has nothing in common with past postwar cyclical recoveries. In their cases, the economy promptly jump-started when the Fed eased. Actually, the same was true around the world. This time, the most aggressive monetary and fiscal pump priming of all times, and now in its fourth year, is showing just mediocre economic effects. The familiar self-accelerating recovery remains elusive.

For us, this flagrant divergence in policy traction has a distinct reason. The monetary easing in the wake of past recessions had an entirely different character than that of the last few years.

Past recessions had their decisive cause in monetary tightening by central banks, putting a brake on borrowing and lending. In turn, the monetary easing ending past recessions meant in essence that the central banks loosened their brakes on money and credit growth that they had pulled earlier to slow the economy. Freed of these shackles, the basically sound economies promptly took off with a vengeance.

But this regular prompt and strong upward response of the economies to monetary easing had still another main cause that is completely missing this time. Because of the imposed credit restraint, a large cushion of pent-up demand used to accumulate during recessions. Once the credit restraint fell away, this store of suppressed demand erupted. The existence of such pent-up demand was plainly a key condition for the regular, prompt post-recession recoveries.

Assessing the present economic situation, it has to be realized that the Fed's persistent, unusually

aggressive monetary ease was not prone to create pent-up demand. Implicitly, it had the exact opposite effect. Lured by extremely cheap and easy money, the consumer stampeded into an unprecedented borrowing binge to sustain even higher spending. While income growth from wages and salaries has literally collapsed since 2000, his spending is actually up 10% in real terms.

VINDICATION FOR THE FED?

Manifestly, there is general overwhelming optimism about the U.S. economy. Positive arguments abound:

Thirteen rate cuts and the lowest interest rates in decades; runaway money and credit creation; rampant fiscal stimulus; the long and strong rally in the stock market; persistent, massive wealth creation through rising house and stock prices; an impending, powerful boost to output from a widespread need to replenish run-down inventories; reported strong profit gains promising an additional strong boost to business investment, returning job growth; surging commodity prices; and the strong stimulus to exports from the slide in the dollar.

To be sure, a more impressive list of growth-boosting influences is hard to imagine. More and more economic news beating expectations seem to have carried away many people. Late in 2003 there was even widespread talk that strong economic growth in the New Year would soon force the Fed to start pre-empting inflation by tightening monetary policy.

It did not carry us away. Much of what we read and hear reminds us of a book by Paul Krugman, published in 1990, *The Age of Diminished Expectations.* The main subject of the book was the observation that *"relative to what everybody had expected twenty years ago, our economy has done terribly."* Krugman expresses his amazement *"how readily Americans have scaled down their expectations in line with their performance, to such an extent that from a political point of view our economic management appears to be a huge success."*

It seems to us that in particular there is a general perception that the anti-recession policies pursued by the government and the Federal Reserve during the last few years have been a great success, considering above all the rapid sequence of severe shocks imparted to the economy through the bursting of the stock market bubble, Sept. 11, corporate scandals and the Iraq war.

Yet, according to this mantra, America experienced its mildest ever recession. For many people, also outside the United States, all this is just further proof of the U.S. economy's wonderful flexibility and resilience.

In a recent speech to the American Economic Association in San Diego, Fed Chairman Alan Greenspan applauded himself once more for his successful policy with the following words:

"There appears to be enough evidence, at least tentatively, to conclude that our strategy of addressing the bubble's consequences rather than the bubble itself has been successful. Despite the stock market plunge, terrorist attacks, corporate scandals, and wars in Afghanistan and Iraq, we experienced an exceptionally mild recession — even milder than that of a decade earlier."

He offered mainly two explanations — *"notably improved structural flexibility"* and *"highly aggressive monetary ease."*

AMERICA'S WORST RECESSION

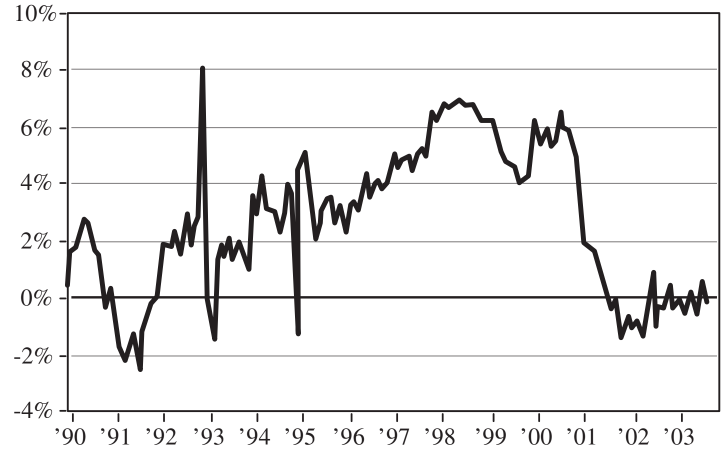
We are tempted to say that we disagree with every single word. In the first place, we reject the general perception of America's *"exceptionally mild recession."* Measured by real GDP growth, that certainly appears true. But that is a very arbitrary measure. The officially declared end of the recession in November

2001 was by no means the end of the bubble's painful aftermath.

That painful aftermath has continued for more than two years, and not only in terms of protracted, sluggish GDP growth, but above all in America's by far worst postwar performance in employment and associated growth in wage and salary income.

Consider: While real GDP surged in the third quarter at an annual rate of 8.2%, wage and salary income adjusted for inflation edged up at an annual rate of 0.8%. Citing Paul Krugman: In the six months that ended in November 2003, income from wages and salaries rose only 0.65% after inflation. For most workers real wages are flat or falling even as the economy expands. For America's employees and workers, numbering almost 150 million people, there has been no recovery.

Growth in Wages and Salaries Less the PCE Deflator (% change year over year)



Source: Bureau of Economic Analysis & Merrill Lynch

In light of these facts, all talk of America's mildest recession in the whole postwar period is outright absurd. It plainly serves to delude people. GDP numbers are an abstract statistical aggregate. What truly counts for people is what happens to their employment and their income. By these two measures, the U.S. economy is experiencing its longest and deepest recession since the Great Depression of the 1930s.

For the bullish consensus, this tremendous, unprecedented discrepancy between real GDP and employment growth in the United States finds its ready and also most convenient explanation in the simultaneously reported record-high, unprecedented productivity growth, accruing from corporations that are becoming marvelously efficient through cutting labor costs.

We do not buy this explanation. It does not make any sense to us. Investigating the relevant statistics, the first thing to note is that the U.S. economy's growth pattern since the early 1980s has become increasingly geared toward consumption. Its share of GDP during these years has steadily risen from barely 63% to recently 70%. For most other industrialized countries this share is between 50–60% of their GDP. Since end-2000, the U.S. recession's start, consumer spending has accounted for 101.6% of real GDP growth.

To us, an economy in which consumption has been taking a steeply rising share of GDP for years is in essence an economy ravaging its savings and investments, both being normally the key source of productivity growth.

In consideration of these and other facts, we feel flatly unable to buy America's trumpeted productivity miracle. In past letters, we have repeatedly pointed to one obvious statistical source: artificially low inflation rates.

We made a simple test by comparing both real and nominal GDP growth between the United States and the eurozone over the period from end-2000 to the third quarter of 2003.

Measured by real GDP, the U.S. economy grew overall by 6.9%, compared with 4.5% for the eurozone. But measuring by nominal GDP growth, the difference contracts sharply — a U.S. growth rate of 13.1%

over the whole period compares with 12.2% for the eurozone.

As we have repeatedly pointed out, the U.S. economy's superior growth performance during the past few years, measured after inflation, had its source largely, though not solely, in the application of lower inflation rates. For the United States, the price deflator for GDP in the third quarter of 2003 since end-2000 had risen a mere 5.8%, as against a reported 7.5% for the eurozone.

Considering the U.S. economy's parabolic credit excesses, the relationship between inflation rates should be the opposite. But pressured by politicians and in particular by Mr. Greenspan to produce the lowest possible inflation rates, America's government statisticians have worked hard to comply, in particular by counting quality improvements as price reductions. Understating inflation rates, in turn, overstates real GDP. A more accurate GDP deflator would lower real GDP growth to a rate that would certainly correlate better to the poor employment performance.

In our view, the prevailing perception that the U.S. economy continues to perform exceedingly better than the eurozone economy needs drastic revision. That particularly applies to the job market.

For decades, all through the postwar period, job creation has been the U.S. economy's outstanding superior feature among the industrialized nations. But that has radically changed. Since 2000, America is by far the worst performer in this respect. Following past postwar recessions, payroll employment was on average up 4% after two years. This time, it is down almost 1%. Something very ominous is going on.

Europe's job market has had a very bad track record for more than two decades. But during the last three years, while American employment plunged, European employment has been more or less stagnant, on a high level, to be sure.

U.S.-EUROPEAN POLICY CONTRAST

Manifestly, there are growing differences both in thinking and in policies. The ones that are increasingly intriguing us are the dramatic differences that have developed in economic and financial perception. Never before has an economy been treated with such massive monetary and fiscal stimulus as the U.S. economy in the last three years. What makes it so particularly interesting is the tremendous contrast in policy measures to Europe. Over these same years, the economy of the eurozone has received next to no policy stimulus. Rising budget deficits are under threat of penalty.

As to fiscal policy, in three years the U.S. public sector financial balance has seen a staggering shift from a cash flow surplus of 2% of GDP to a deficit of almost 5% of GDP, stemming from massive tax cuts and rising expenditures. In the case of the eurozone, public sector indebtedness amounted at end-2002 to 69% of GDP, after 69.6% in 2000 and 75.4% in 1996.

No less staggering are the differences between the two continents in monetary policy. Since the end of 2000 America has experienced an interest rate collapse at the short end from 6.5% to 1%. It was, in fact, the single most aggressive monetary easing in history of any central bank in such a short period of time.

In contrast, the European Central Bank (ECB) reduced its short-term rate comparatively slowly from 4.75% to 2%. Effects on the rate of new borrowing have been more than modest. It is funny to compare the ECB's terminology in this respect with what is happening in the United States.

In its December report, the bank speaks of a rapid increase in consumer borrowing, describing acceleration in the third quarter of 2003 to an annual rate of 6.75% from 6.4% in the prior quarter. Relative to GDP, total consumer indebtedness rose to 52%, after 51.5% in the prior quarter. Borrowing by nonfinancial businesses has slumped to an annual growth rate of 5.25%, after more than 13% in late 2002. In relation to GDP, their total now amounts to 65%.

It is, of course, a most interesting question what, actually, is keeping the European authorities so cool in the face of protracted economic weakness, flagrantly contrasting with the hectic activism of the U.S. authorities? And remarkably, too, there is little protest from businesses and the public.

We presume two main reasons for this reluctance to act more aggressively: *first*, the many years of bad experience with deficit spending of governments, in particular during the 1970s, are not forgotten. There is overwhelmingly no desire to repeat this folly. As to monetary policy, there is — *second* — a widespread perception that interest rates are reasonably low, and that further small cuts would not be helpful.

POLICY TRACTION

"Policy traction" is an expression that lately has come into fashion. In essence, it is about the relationship between the size of the monetary and fiscal stimulus injected into an economy and their effect on economic growth and employment.

In the past three years America has experienced an interest rate collapse, a record fiscal stimulus, the loosest monetary policy imaginable fueling money and credit creation at a scale that has no precedent in history. Has it really worked?

Well, in one way it had fabulous traction. It engendered the greatest credit and debt bubble in history. Total outstanding debt, financial and nonfinancial, in the United States has ballooned by almost $6,500 billion since 2000, as against GDP growth of $1,238 billion. For each dollar added to GDP, there were about six dollars added to indebtedness.

And it had fabulous traction in a second way: The runaway money and credit creation went with a vengeance into asset markets — stocks, bonds and housing. When the equity bubble popped in early 2000, the consumer simply moved on to the housing bubble that had been waiting in the wings, helped by the Fed-inspired bond bubble driving mortgage rates sharply downward.

Their joint result was the unprecedented mortgage finance excess. While businesses were slashing the consumer's income growth, he offset this income loss largely by stepping up his borrowing.

Yet in the course of 2002 it became clear that the lowest short-term interest rates in nearly half a century were failing to create the customary strong economic recovery. In June, the Fed cut its interest rate for the 13th time, to 1%, a 45-year low. In the following month, it admitted in its report to Congress the fact that the economic performance during the first half of the year had remained subpar.

On the other hand, however, the Fed stressed the success of its easing by mentioning the recent rise in stock prices, the sharp narrowing of credit spreads on corporate debt, the strong housing and mortgage refinancing market and rising consumer sentiment.

What, in fact, had emerged was an unprecedented dichotomy in the effects of the Fed's most aggressive monetary easing between economy and financial markets. Instead of jump-starting consumer and business spending, the extreme monetary looseness and rock-bottom short-term interest rates generated multiple, price bubbles in the stock, bond, mortgage and housing market.

Without great discussion, the U.S. economy has been shifting to a growth model that radically differs from past experience. In the old model that has ruled for centuries, monetary easing was conceived to work directly on the real economy, and it could be counted on to promptly do so. But it was a world with low debts and strong employment and income growth.

Most importantly, it was a world in which financial systems of very limited size principally served as mere conduits for channeling savings into capital investment, creating national wealth in the form of

productive plant and equipment, and commercial and residential buildings.

NEW BUBBLES TO THE RESCUE

Faced with an economy that responded too poorly to its aggressive monetary easing, and with very little scope for further cuts in short-term interest rates, a desperate Fed reacted in an unconventional way. Internally, it was obviously considered to increase policy traction by bringing also long-term rates down.

Wanting to avoid direct intervention, it was apparently decided to put America's highly vigilant, huge financial and speculative community before the cart, simply by using opportune rhetoric. Repeated public talk by Mr. Greenspan and other Fed members of looming deflation in the economy was one bit of bait. Simultaneous talk of two new policy considerations was the other.

The one was to repeat in public an explicit commitment to maintain the existing rock-bottom short-term rate peg of 1% as far "as the eye can see"; and the other one were public hints that "unconventional" measures, like direct purchases in the market, were being considered to push long-term rates further down as well.

It was really an unreserved invitation to investors and speculators around the world for greater engagement in playing America's yield curve with heavily leveraged carry trade. Many heard and acted promptly. In just six weeks, U.S. 10-year yields fell from 3.9% to 3.1%.

It should, by the way, be clear that this manipulated indirect intervention vastly outdid what the Fed could have possibly done with direct purchases. We have no idea about the scale of the purchases that suddenly flooded the U.S. bond market, but it was without question in the range of several hundred billion dollars.

What followed is well known: A frenzied stampede of the financial community into the highly leveraged bond carry trade sent bond yields plummeting, pulling in their wake highly correlated mortgage rates sharply downward with them. In the same vein, the loose money helped to boost house prices.

Given in addition extremely aggressive mortgage lending institutions, eager to lend prodigiously against rising house prices, consumer borrowing just went parabolic.

All in all, four interrelated bubbles have kept the U.S. economy going after the bursting of the stock market bubble in 2000: rising house prices, falling bond yields and mortgage rates, and soaring mortgage loans feeding the consumer spending binge. Yet the key role fell manifestly to the bond bubble. By pulling mortgage rates precipitously down, it provided the big bait that lured house owners to capture the offered big savings in current interest rate service by refinancing and increasing their mortgage.

This takes us to the most important issue of this development in the United States. It is the traction that these policies have so far achieved, and its probable economic and financial effects in the longer run.

It appears to be the general impression that the monetary and fiscal stimulus injected into the United States during the third quarter almost worked wonders with the reported real GDP growth of 8.2%. From a more comprehensive view, we see very disappointing traction.

POLICY SUCCESS OR FAILURE?

How to measure policy traction? Earlier we compared America's GDP growth with that of the eurozone and noted that its superior growth rate in real terms owed mainly to a dubious difference in calculated inflation rates. Comparing, on the other hand, the massive monetary and fiscal stimulus imparted to the U.S. economy with the near-zero stimulus imparted to the eurozone economy, we draw rather negative conclusions about the U.S. economy's viability.

Assessing policy traction in 2003, now consider the following three figures concerning the consumer's finances in the second and third quarter of last year. His disposable income grew during the two quarters with the help of tax cuts by $267.4 billion. With his spending in the national product up $230.2 billion, he actually saved part of the income gain. But he borrowed $969.5 billion (all numbers at annual rate).

We would not say that these numbers suggest tremendous policy traction. The borrowing binge went vastly into the purchase of stocks and housing, boosting their prices, according to new semantics now called wealth creation. Surging stock and house prices, in turn, generated surging collateral for still more consumer borrowing.

It seems that American policymakers and most economists see no problem in this development. Many appear to think of it as a new, more efficient policy device to stimulate economic growth. Former income-driven economic growth has simply been replaced by wealth-driven growth.

Frankly, this is absurd economics wrought with follies and fallacies, of which two are immediately obvious: *first*, translating into exorbitant debt levels, the credit excesses are unsustainable; and *second*, economic growth becomes increasingly distorted toward personal consumption. Since 1995, its share of GDP has escalated from 65% to 70.6%. This is actually a main reason why we doubt the possibility of a sustained U.S. economic recovery.

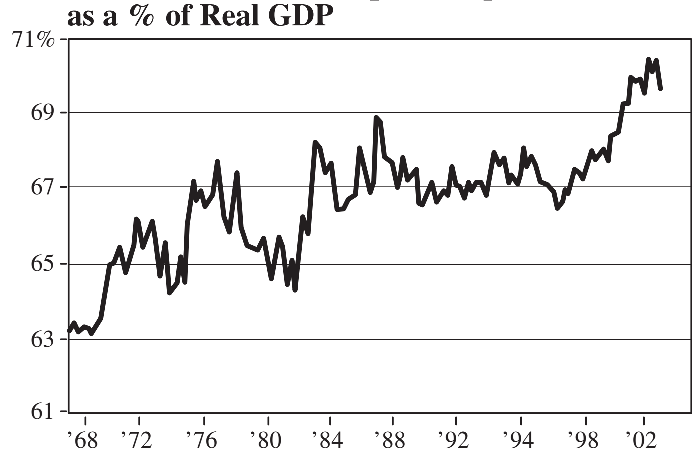
During past recessions, caused mainly by monetary tightening, a large cushion of savings and "pent-up" demand used to accumulate across the whole economy. As soon as the Fed eased, this "pent-up" demand shot up with a vengeance.

But this time, with savings at a record low and consumer spending at a record high, the consumer already seems to have his regular post-recession spending binge behind him, rather than before him.

But we have to admit to principal misgivings about the idea of stimulating consumer spending with near-zero interest rates. This puts the focus exclusively on the borrowing consumer. But many millions of households who have counted on the income from their accumulated savings for their retirement are largely invested in financial assets — stocks and interest-bearing assets, such as bonds, time deposits and money market funds — the income from which has collapsed.

Yet everybody sees only what the borrowing consumer is gaining. Nobody seems to think about the big income losses that have hit the net savers of the nation in the same vein. As interest earnings of private households substantially exceed their interest expenses as a whole, the income losses of the savers are sure to outrun the income gains by the borrowers over time. Besides, these extremely low interest rates drive many savers into high-risk investments.

Real Personal Consumption Expenditures as a % of Real GDP



Source: www.prudential.com/yardeni

ON THE ROAD TO INFLATION OR DEBT DEFLATION?

Plainly, the report of the U.S. economy's record-high growth rate of 8.2% in the third quarter of 2003 has played a key role in kindling a general euphoric perception that it was now definitely on the road to a sustained and essentially self-accelerating recovery.

It is our view that the low inflation rates have grossly deluded many people about the malign economic and financial imbalances and distortions that have accumulated in the U.S. economy under the impact of unprecedented credit excesses, and that keep impairing new, healthy economic growth.

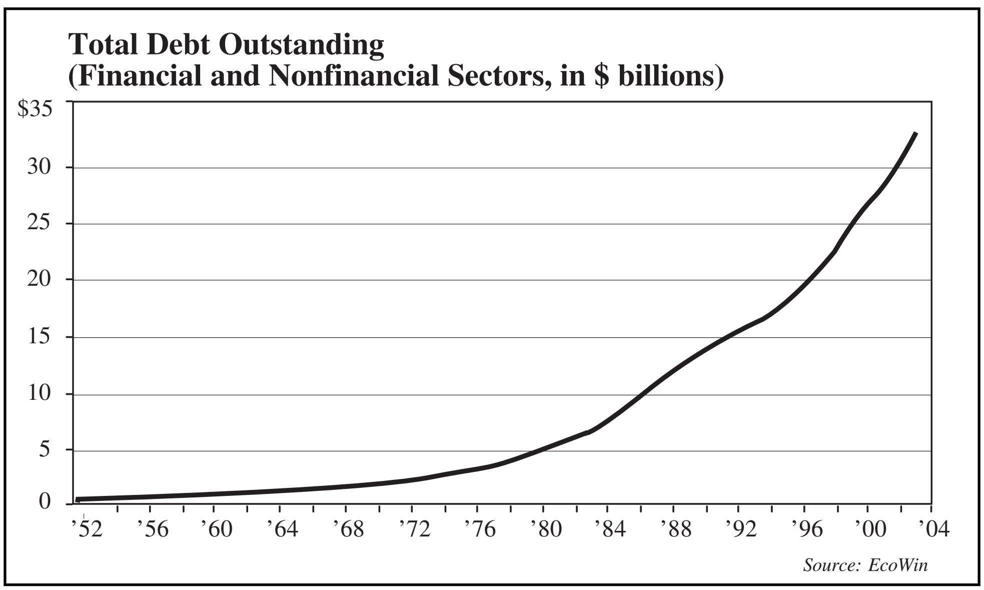
Perhaps we should start by briefly taking stock of these credit excesses. As the following chart shows, they really started in the late 1970s, followed by increasingly rapid escalation in the 1980s and 1990s.

There seems to be a widespread view that the runaway money and credit creation of the past few years will, sooner or later, implicitly gain the upper hand and generate stronger economic growth with higher inflation rates. Many regard the inflation in commodity prices as an early indicator in this respect.

Viewing inflation exclusively as a rise in the prices of goods and services, as measured by consumer and producer prices, is the first big mistake. First of all, we must distinguish between the cause and effects of inflation. There is always one and the same cause: a credit expansion in excess of savings, conventionally called credit inflation. But there can be very different effects.

Credit inflation primarily creates excess demand, but according to circumstances this can take different directions. In principle, there are three different potential outlets: *first*, consumer and business spending in the economy; *second*, purchases of existing assets; *third*, purchases of foreign products or assets.

Until the late 1970s, credit excess worldwide went overwhelmingly into consumer and business spending, regularly associated with consumer and producer price inflation. But this pattern of inflation changed in the 1980s. While credit inflation sharply accelerated, consumer and producer price inflation sharply slowed.



How to account for this contrary movement? For many it was the first sign of an economic miracle. In reality, credit inflation had vastly changed direction. Due to a drastic change in the pattern of spending, a growing part went into the stock market (mergers and acquisitions) and into imports, as reflected in the soaring U.S. trade deficit and the plunging dollar. Inflation had not disappeared. It had shifted away from national product and into asset markets (mainly stocks) and the soaring trade deficit.

When the Fed returned to protracted monetary looseness in 1995, this new pattern of spending and related inflation effects soon went to new extremes. Total private outstanding debt soared by $4,734.5 billion, or 47%, between 1995–2000. It was enough to fuel rampant inflation across the board — in asset prices, stocks in particular, as well as in spending on goods and services, fueling strong GDP growth. Actually, consumer spending increasingly exceeded domestic production. But instead of going into price inflation, it fueled the soaring trade deficit.

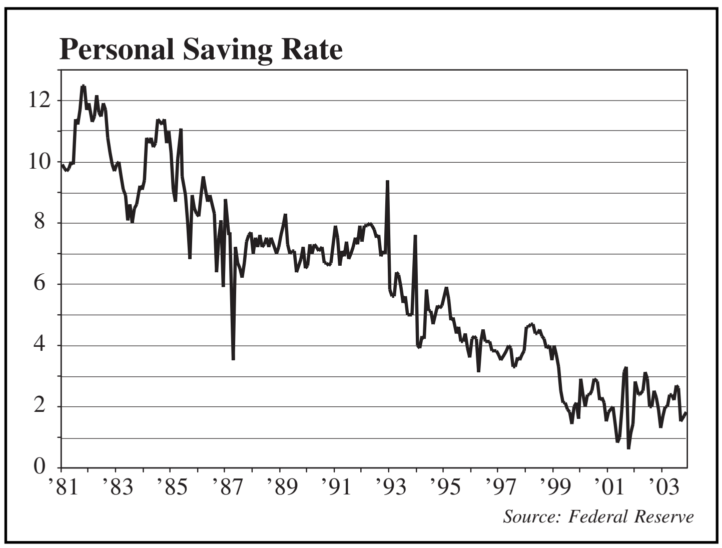
Mistaking the rapidly inflating stock prices for rising wealth, private households stampeded into an unprecedented borrowing and spending binge at the expense of their savings from current income. Consumption soared as a share of GDP, while the personal savings ratio — personal savings relative to disposable income — plunged from 9% in the late 1970s to lately 2% of disposable income.

The trouble, from a macro perspective, is that personal saving was not alone in plummeting. Government and business saving did too. Taken together, net national saving in the third quarter of 2003 was down to an annual rate of 1.5% of GDP, coming from 6.5% in 1998. That is its lowest level in the United States since the Great Depression of the 1930s.

What is wrong with a country that gets rid of its domestic savings? In the U.S. case, it refutes, first of all, the prevailing perception that the boom of the late 1990s was investment-driven. Its outstanding feature was unprecedented consumption excess that essentially decreased the share of GDP that is available for investment. It needs saving from current income to make capital investment possible.

Soaring stock prices and soaring consumer borrowing turned the U.S. economy into a bubble economy. The essence of a bubble economy is that soaring asset values induce borrowing and spending binges. But it depends on the particular economic and financial circumstances in every country on what the bubble money is mainly spent. In the U.S. case, the equity bubble led to a frenzied consumer borrowing and spending spree. In Japan, by contrast, the developing stock and real estate bubble fueled an overexpansion of credit for business investment and commercial building.

Pondering now whether the U.S. economy is on the road to inflation or deflation, we have to return to our earlier distinction between the three different outlets: *first*, spending in the economy; *second*, purchases of existing assets; and *third*, outflows abroad.



Now the crucial point about this distinction between various outlets for credit excess is their radically different economic and financial effects. Of the three different outlets, only spending in the economy generates higher GDP, higher incomes and possibly also into higher inflation rates.

Credit inflation, going into asset markets and imports, has none of these three effects. In total, America's credit excesses escalated to unprecedented extremes in the 1980s and in particular in the late 1990s and early 2000s, but the pattern of their use changed dramatically. But they went increasingly and then overwhelmingly into asset markets and imports.

Economist John Maynard Keynes, by the way, used to distinguish between financial and industrial circulation. It was his fear that the financial circulation might steal too much money from the industrial circulation. Another distinction of the same kind, used by some economists in the past, is between capital circulation and income circulation.

Since the bursting of the stock market bubble in 2000, credit excess in the United States has gone parabolic. In 2002, runaway credit growth of $2,286 billion compared with available net national savings of $250 billion. But the key question is where all that borrowed money went.

Our focus is on the conditions in the second and third quarter of 2003, during which the current recovery started. Nominal GDP grew overall by $371.2 billion (all numbers again at annual rate). As mentioned earlier, the consumer's disposable income increased by $267.4 and his spending by $230.2 billion. But his borrowing soared by $969.5 billion.

Observing permanent, unbridled money and credit inflation in the United States, the great question in many people's mind is why it creates no inflation in the economy. Well, it did cause rampant inflation, but not in the national product or the real economy. It occurred in the two areas into which the consumer has poured his borrowed money: soaring imports and soaring asset markets.

LOCKED-IN LIQUIDITY

This immediately raises the next great question that is repeatedly posed to us: Couldn't all this excess liquidity in the financial markets one day flood into the real economy, boosting inflation in consumer and producer prices?

Our answer is a categorical no. First of all, the excess liquidity went into fixed assets, having boosted their prices. But to move money out of these assets and into the real economy now would require the sale of such assets against cash. Undertaken at a major scale, however, this would merely depress asset values because invested money is in the aggregate definitely locked in.

To flee into "real goods," the investor has to find other people who are ready to take his asset against their cash, and that means that a net money inflow out of the financial markets and into the economy cannot take place. Therefore, when the stock market crashed in 2001–02, no money exited. Only prices changed. No money moves. Markets are liquid only as long as buyers predominate. They become illiquid when sellers predominate. Liquid markets can turn illiquid overnight, without any contraction in the money supply.

We come to the final and most important questions: sustainability and long-term effects of this extremely unbalanced economic and financial developement.

Trying to answer these two questions, we must look at three items: *first*, asset creation; *second*, income creation; and *third*, debt creation.

The key point to see here is that income growth from wages and salaries has literally collapsed, even though economic growth has sharply accelerated. Another anomaly is the continuous, unusually steep rise in indebtedness, mainly on behalf of consumers and the government.

Over the year to the third quarter of 2003, the value of houses, stocks and mutual fund shares owned by private households increased by around $2.5 trillion. Debts increased by around $1 trillion. Total personal income grew $298.5 billion and wage and salary disbursements by $123.2 billion.

ON THE ROAD TO DEBT DEFLATION

For the notorious bulls, these are beautiful numbers, showing a consumer getting richer and richer while spending more than he earns. For people with a little common sense, this cannot be true.

Our differences of opinion with the bullish consensus about the economic and financial situation in the United States have many reasons. One of them is a radically different apprehension of wealth and wealth creation. America's policymakers and economists view asset inflation as wealth creation as if this were a self-evident fact. What this asset inflation truly generates is phony collateral for runaway consumer indebtedness, luring the consumer into unprecedented debt excesses. It is phony wealth creation because unlike the real wealth creation through capital investment, both its creation and its use involve no income creation.

This perception of wealth creation, actually, runs completely counter to traditional thinking in economics. It has always been apodictic in economics that there is but one way to create genuine wealth for an economy as a whole, and that is to consume less than current production or income. Wealth creation from the macroeconomic perspective essentially occurs through saving and investment in tangible, income-creating plant, equipment, and commercial and residential buildings.

Guided by the Greenspan Fed, America is practicing a radically different pattern of "wealth" creation. An extremely loose monetary policy forces up asset prices, providing both the impetus and collateral for higher borrowing. Being offered almost limitless credit at rock-bottom interest rates, the consumer responds with a frenzied borrowing and spending binge.

The crucial thing about this new American way of wealth creation is that it takes places entirely outside the national product. Its gist is to inflate asset prices by inflating credit. But what gives it such great dynamics is the conventional practice to value the vast mass of existing shares and houses in line with movement of the price of the last, marginal trade.

It is really like printing wealth.

The crucial concern is the inherent effects of this so-called wealth creation to the economy. Asset inflation by itself has no effects at all. Its economic effects arise only from the associated increase in consumer borrowing and spending. But that has two highly malign effects. An endless escalation of unproductive debt is one. The other is that consumption takes an ever-greater share of GDP. Overconsumption is, really, America's deep-seated, structural disease, and asset inflation is worsening it.

Grossly distorted economic growth at the expense of saving and investment is one dangerous legacy of America's asset inflation. The exponential rise in the consumer's indebtedness in relation to his badly lagging income growth is the other. A savage debt deflation is the inevitable outcome. But this kind of deflation does not lower interest rates. It boosts them. Basically, the Fed has lost control.

CONCLUSIONS:

U.S. economic growth is no longer based on saving and investment. Its essence is that credit excess provides soaring collateral for still more credit excess creating still more asset inflation for still more borrowing and spending excess. It seems like a perpetual motion machine that just goes on cranking out wealth and spending. It is important to see that the true name of this game is bubble-driven growth, and all bubbles end by bursting. America is the next Japan.

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